Considerations for the effects of rising interest rates on market neutral equity strategies

Written by Invesco Quantitative Strategies

Most market observers consider a rise in US interest rates to be inevitable. The only open questions are when and by how much. Short-term rates, as proxied by the federal funds rate, have been held at zero as a matter of US Federal Reserve policy since December 2008 when the mushrooming global financial crisis called for extreme measures to inject liquidity into paralyzed markets. Now, after more than six years, and against a backdrop of economic growth, a much-improved labor market, and benign inflation, the Fed is deliberating the final details necessary to initiate the interest rate "lift-off" and return to an environment of non-zero interest rates.

Interest rates affect all investments, but not all in the same way and to the same degree. For instance, all else equal, a rise in rates acts as a headwind to fixed income investments, since the future payments of these instruments are worth less when discounted by a higher interest rate. Furthermore, newer issues will have higher coupons, making existing bonds less attractive by comparison. Rising rates generally have a negative impact on stocks as well since a company's cost to borrow increases and their customers have less money to spend due to their own increased borrowing costs.

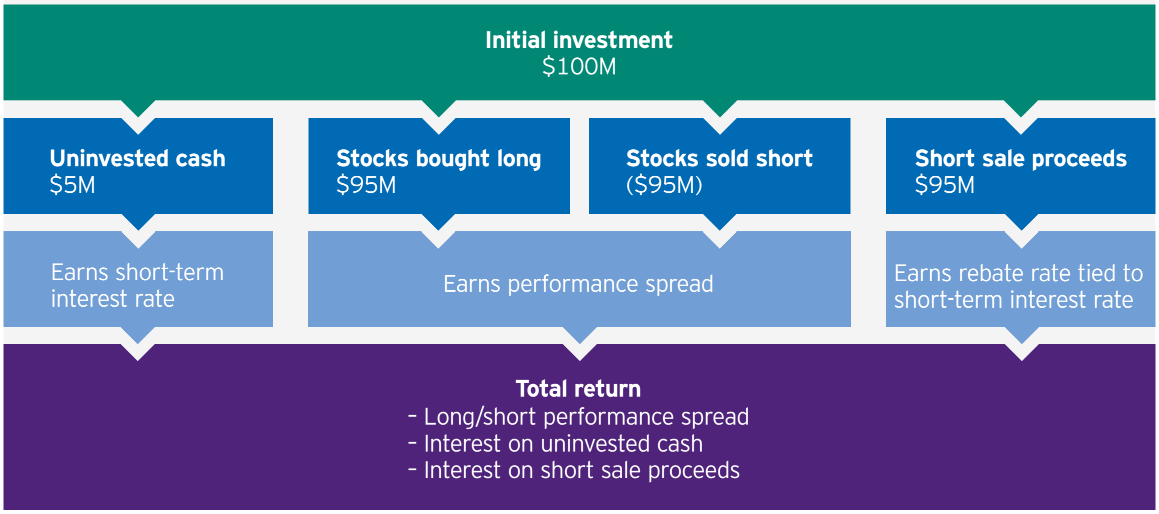
Many investors and their financial advisors seem most concerned about the impact the potential rise in rates will have on their fixed income and interest rate-sensitive investments. Relative to equities, bonds generally have more modest return expectations. If performance suffers due to rising rates, those modest returns may be reduced by an unacceptable amount. From the start of the first round of quantitative easing (QE) in December 2008 to its ultimate end in October 2014, US bonds got strong support from an accommodative monetary policy, and yet bond returns over that six-year time frame lagged those from the prior six years.[1] As the market transitions from the end of QE to a rise in rates, many investors are concerned about the headwind to returns that this environment will cause.

We believe market neutral equity is an investment strategy that warrants consideration as an alternative to bonds in this environment of rising rates. A typical market neutral equity strategy seeks to generate returns that are independent of the movement of general equity markets by earning a performance spread between its long and short holdings. To deliver returns regardless of the direction of the stock market, most market neutral equity strategies create offsetting long and short positions of attractive and unattractive stocks, respectively, which cancel out unwanted exposures, thereby creating a portfolio generating returns from pure stock selection. In this way, a typical market neutral equity portfolio will neutralize exposure along such dimensions as beta, countries (for global portfolios), sectors, and industries. The amount of return generated by the spread between these long and short holdings is ultimately determined by the skill of the portfolio manager as well as the market environment for their particular investment process.

1 Based on the performance of the Barclay's Capital Aggregate Bond Index and the Citigroup 10-Year Treasury Index

While rising rates are a challenge for bonds, they act as a tailwind for most market neutral equity strategies. When market neutral equity managers sell stock short, they receive cash, just as they would in a typical stock sale. This cash acts as collateral for the stocks sold short, and earns a rate of return (known as a rebate rate) that is directly tied to short-term interest rates. As these rates rise, all else equal, the short sale proceeds will earn more money. The following diagram may help clarify the sources of return in a typical market neutral equity strategy. This hypothetical example assumes the portfolio manager receives $100 million to fund a market neutral equity strategy, buys stocks totaling $95 million, sells short $95 million worth of stock, and leaves $5 million uninvested to accommodate cash flows and future portfolio rebalancing.

Sources of return in a typical market neutral equity strategy



Market neutral equity strategies also share two of the same features that make bonds a useful addition to an investor's overall portfolio. First, relative to equities,[2] market neutral equity strategies tend to have lower levels of total volatility. Second, since these strategies typically target near-zero beta exposure, their correlation to long-only equity (and fixed income) investments can be quite low.

All signs appear to indicate a rise in short-term interest rates is on the horizon. Much ink has been spilled guessing the exact date, which has seemingly shifted with the publishing of every economic report. Advisors are grappling with appropriate asset allocations in light of a rising rate environment. While higher rates tend to weigh on fixed income returns, they are not universally detrimental. Market neutral equity strategies may be poised to benefit, since the return they earn on their short sale proceeds is typically tied to the market for short-term interest rates. With the potential for total volatility appreciably lower than equities and attractive diversification potential through low correlations to both equities and bonds, we believe market neutral equity strategies are well worth considering for the coming rising rate environment.

2 For example, the S&P 500 Index

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Short sales may cause an investor to repurchase a security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, exposure to potential loss is unlimited.

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